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UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

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| In re<br><br>GERALD ARMSTRONG,<br><br>Debtor. | Case No. 95 10911 aj<br>Chapter 7<br><br>Adv. Pro. No. 95 1164 |
| CHURCH OF SCIENTOLOGY INTERNATIONAL, a California non-profit religious corporation,<br><br>Plaintiff,<br><br>v.<br><br>GERALD ARMSTRONG,<br><br>Defendant. | Trial Date: February 13, 1996<br>Time: 9:00 a.m.<br>Ctrm: Hon. Alan Jaroslovsky |

**TRIAL BRIEF**

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## I.

## INTRODUCTION

At trial, creditor Church of Scientology International ("the Church") will demonstrate that: (1) the permanent injunction entered against Armstrong by the state court enforcing the underlying contract is not dischargeable in these proceedings; (2) Armstrong is not entitled to discharge, pursuant to 11 U.S.C. §727(a)(4)(A), of his debt to the Church[1] because he made false statements under oath in his bankruptcy petition; and (3) Armstrong is not entitled to discharge, pursuant to 11 U.S.C. §727(a)(5), because he dissipated his assets without a satisfactory explanation. These are the narrow issues before this Court in this adversary proceeding.

Armstrong would like to expand this trial into a trial of the Scientology religion, a re-trial of the state court action, and an opportunity to portray himself as a pitiable "victim" of the very litigation which he created. None of those matters are relevant to the issues actually before this Court, and all are proffered solely to create prejudice. On October 6, 1995, this Court correctly identified the issues which would be tried in this action [Ex. 20, Transcript].[2] Taking the Court's admonitions to heart, the Church has made every effort to streamline its case, and to limit the trial even further to the three narrow issues identified above. Armstrong's defense should be restricted to the presentation of evidence and argument that is relevant to those issues and not duplicative of his voluminous state court filings.

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[1] Armstrong has reaffirmed all of his monetary obligations except for the Church's claim, leaving the Church the only creditor with an interest in these proceedings. [Plaintiff's Exhibit 11, Transcript of Proceedings, May 17, 1995, 7:24]

[2] Unless otherwise noted, all references to Exhibits are to Plaintiff's Proposed Exhibits, which have been given to the Court in an indexed binder for easy reference.

## II.

## PROCEDURAL HISTORY

Armstrong and the Church entered into a settlement agreement in December, 1986 [Declaration of Lynn R. Farny ("Farny Dec."), ¶8a, and Ex. 1], hereinafter "the Agreement." Pursuant to that Agreement, the Church paid a lump settlement amount to Armstrong's lawyer. [Farny Dec. ¶8b] Armstrong has testified that his portion of the settlement amount was $800,000, and claims he received $518,200, after expenses [Ex. 15, at 535-536; Ex 16, at 33].

Prior to signing the Agreement, Armstrong and the Church had been engaged in litigation with each other. Armstrong was also employed by attorney Michael Flynn as a paralegal in Church-related litigation, and was very active in encouraging and fomenting additional litigation against the Church. In order to end all of the litigation and achieve peace, the Church agreed to settle with Armstrong only when he agreed to a series of non-disclosure and non-assistance provisions which were intended to prevent him from further pursuing litigation-related activities against the Church [Farny Dec., ¶8c].

Armstrong began breaching the non-disclosure and non-assistance provisions of the Agreement in the early 1990s. When he refused to stop breaching the Agreement, suggesting instead that the Church pay him additional money if they wanted him to abide by the non-disclosure provisions, the Church brought an action to enforce the Agreement. After three years, one interlocutory appeal (Armstrong's), and two changes of venue, the Marin County Superior Court awarded the Church a final judgment of $300,000 in liquidated damages for breach of contract, together with a permanent injunction prohibiting Armstrong from further violations.[3]

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[3] A non-complete explanation of the Marin County litigation can be found in the Declaration of Lynn Farny, ¶8g - ¶8t, which will not be repeated here. Mr. Farny's declaration is incorporated herein by reference.

Since the entry of the permanent injunction in October, 1995, the Church is not aware of a single new breach by Armstrong [Farny Dec., ¶9]. Given that the state court found that Armstrong had deliberately breached the Agreement more than 34 times while the Marin County litigation was pending, this alone is eloquent testimony that the injunction -- and only the injunction -- is actually working to keep the peace that the Church bargained and paid for in 1986.

This Court gave the Church permission to conclude the Marin County action so that a final determination could be made therein of the Church's entitlement to an injunction and damages. That determination has now been made. It remains for this Court to decide whether some or all of that judgment will survive these bankruptcy proceedings.

## III.

## THE PERMANENT INJUNCTION ISSUED BY THE STATE COURT IS NOT DISCHARGEABLE IN BANKRUPTCY

### A. The Facts Relevant To The Issuance Of The Injunction Have Already Been Decided By The State Court.

The facts which support the Church's request that this Court find that the permanent injunction issued by the superior court is non-dischargeable have already been established in the Marin County proceedings. In entering its Order of Permanent Injunction on October 17, 1995 (hereinafter, "Permanent Injunction"), the superior court found that:

> 1. Plaintiff and defendant freely and voluntarily entered into a Mutual Release of All Claims and Settlement Agreement ("Agreement") in December, 1986.
>
> 2. Plaintiff performed all of its obligations pursuant to the Agreement.
>
> 3. Defendant Armstrong received substantial consideration for the promises which he made in the Agreement.
>
> 4. Since 1990, defendant Armstrong has repeatedly breached paragraphs 7(D), 7(E), 7(H), 7(G), 10, 18(D) and 20 of the Agreement.

[Ex. 8 (C), Order of Permanent Injunction, p. 2].

The superior court also found that Armstrong intended to continue breaching the Agreement "unless he is ordered by the Court to cease and desist." [*Id.*, at 6] Applying California law to the factual findings, the court held:

> Plaintiff's legal remedies are inadequate insofar as the scope of the relief ordered below is concerned. *Tamarind Lithography Workshop, Inc. v. Sanders*, 143 Cal.App.3d 571, 577-578, 193 Cal.Rptr. 409, 413 (1983).
>
> Accordingly, the Court finds that entry of a permanent injunction in this action is necessary in this action because pecuniary compensation could not afford the Church adequate relief, and the restraint is necessary in order to prevent a multiplicity of actions for breach of contract. Civil Code § 3422(1),(3).

[Id. at 6]

The Permanent Injunction is a narrow, prohibitive injunction, designed to prevent Armstrong from engaging in the conduct which the Court found had been breaching the Agreement, including, voluntarily assisting litigants or claimants against the Church and other scientology-related entities; facilitating in the creation or publication, in any medium, any work of any kind discussing or referring to Scientology; and discussing Scientology with anyone, other than his immediate family.[4] Since the injunction was entered in October, 1995, Armstrong appears to have suspended his breaches of the Agreement, at least for the time being.

Each of the objections to the Permanent Injunction which Armstrong raises in his voluminous declarations herein was raised to the superior court in lengthy proceedings, and rejected [Farny Dec., ¶¶8h-8r]. He is collaterally estopped from re-litigating these same issues here. The doctrine of collateral estoppel applies in dischargeability proceedings. *Grogan v. Garner*, 498 U.S. 279, 284 & n. 11, 111 S.Ct. 654, 658 & n. 11, 112 L.Ed.2d 755 (1991); *In re Bugna*, 33 F.2d 1054, 1056 (9th Cir. 1994). In determining the collateral estoppel effect of

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[4] Armstrong moved for reconsideration of this Order on December 1, 1995. His motion was denied.

a state court judgment, the federal courts must apply that state's law of collateral estoppel. 28 U.S.C. § 1738; *Kremer v. Chemical Construction Corp.*, 456 U.S. 461, 481-82, 102 S.Ct. 1883, 1897-98, 72 L.Ed.2d 262 (1982). California law holds that collateral estoppel bars relitigation when,

> (1) the issue decided in the prior action is identical to the issue presented in the second action; (2) there was a final judgment on the merits; and (3) the party against whom estoppel is asserted was a party. . . to the prior adjudication.

*Garrett v. City and County of San Francisco*, 818 F.2d 1515, 1520 (9th Cir. 1987). In this case, the criteria are easily met: the state court action occurred between the same parties; the Church's entitlement to a permanent injunction was fully litigated; and the state court has entered a final judgment [Ex. 8].

Moreover, once the criteria for collateral estoppel have been met, it is error for the bankruptcy court to permit a debtor to relitigate issues. *In re Bugna, supra.* In *Bugna*, the creditor obtained a California state court judgment against the debtor, after jury trial, for fraud and breach of fiduciary duty. When the debtor then filed for bankruptcy, the creditor brought an adversary proceeding pursuant to Bankruptcy Code section 523(a)(4). The bankruptcy court found that collateral estoppel precluded the debtor from relitigating the issues of fraud and breach of fiduciary duty, and the debtor appealed. Applying California law of collateral estoppel, the Ninth Circuit soundly rejected the debtor's relitigation attempts, holding:

> Bugna claims the bankruptcy court erred in refusing to reopen the issues of fraud and breach of fiduciary duty. To the contrary, the court would have erred had it permitted relitigation of these issues. Bugna has had his day in court; in fact, he has had many days in court, at great expense to [the creditor] and at great burden to the judicial system. Incurring these costs a second time is precisely the evil the doctrine of collateral estoppel is designed to prevent. . . . Once a party (like [the creditor] here) has won a final victory on an issue, it is entitled to avoid relitigation of that issue in any other forum. The bankruptcy court's otherwise broad powers do not include the power to reject a party's invocation of collateral estoppel on an issue fully and fairly litigated in another court.

33 F.2d at 1057-1058.

So, here, Armstrong has already had a great many days in court litigating the issues relevant to the Permanent Injunction. He is not entitled to exhaust the resources of this Court relitigating them here.[5] Further, as discussed below, the cases consistently hold that state court determinations concerning whether or not an equitable remedy is necessary and appropriate are controlling in bankruptcy actions, because the issues to be determined are matters of state law.

**B. The Injunction Is Not Dischargeable.**

Bankruptcy Code Section 727(b) provides that all debts or liabilities on a "claim" which arose prior to the filing of bankruptcy by a petitioner can be discharged. Section 101(4) defines "claim" to mean:

> (A) right to payment . . .; or
>
> (B) *right to an equitable remedy for breach of performance if such breach gives rise to a right to payment,* whether or not such right to an equitable remedy

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[5] Armstrong, for example, attempts to argue that he "is not precluded by the settlement agreement from responding" to what he terms "attacks" by Church members, and asks the Court to "read the settlement agreement" and decide differently [Armstrong Dec., ¶3]. What he does not tell the Court is that this issue has been reviewed not just by the Honorable Judge Gary W. Thomas in the Marin County action, but by two additional superior court judges and the Second District Court of Appeal. Armstrong raised this issue before the Honorable Ronald M. Sohigian of the Los Angeles Superior Court [Ex. 5]. When the Church was awarded a preliminary injunction, Armstrong appealed it and again made the same argument. The Court of Appeal affirmed Judge Sohigian [Ex. 6]. Armstrong cross-claimed against the Church for breach of contract, arguing that the Church had a duty not to discuss him. Demurrer to the cross-complaint was sustained in 1994, the Honorable David M. Horowitz, who specifically ruled that the non-disclosure provisions of the Agreement were not reciprocal [Ex. 7]. Judge Thomas then made a similar finding on the Church's application for summary judgment of its claims for breach of contract and made it a part of the final judgment [Ex. 8]. Under these circumstances, Judge Thomas's ruling is hardly a "mystery," to Armstrong or anyone else. For Armstrong to plead with this Court to review the Agreement yet again and effectively overrule all of the state court judges who have patiently reviewed this matter of state contract law mocks the seriousness of these proceedings. To the same effect are his claims that the contract is unenforceable, was the product of duress and the other Affirmative Defenses raised in Armstrong's answer. [See Farny Dec., ¶¶8h-8r, and Exhibits 5-9] If he disagrees with the entry of the permanent injunction, his remedy is to appeal the decision of the superior court, not attempt to re-try his defenses here.

is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

A survey of the reported cases dealing with the survival of equitable remedies in a bankruptcy context discloses that the weight of authority overwhelmingly precludes the discharge of the Church's permanent injunction. Of the 21 primary cases which discussed the question, all but 3 bankruptcy courts reached the conclusion that the creditor in question was permitted to pursue his equitable remedies even after the debtor was discharged in bankruptcy. Moreover, every appellate court decision found supports the survival of the injunction. The cases hold that: (1) whether or not an equitable remedy should issue, and whether or not there is an equivalent legal remedy are issues of state law; (2) where state law provides the creditor with an equitable remedy and legal remedies are inadequate, the equitable remedy is not reducible to a claim for money which can be discharged in bankruptcy; and (3) this is true whether the right to the equitable remedy arises from a contract or as a matter of state law.

In the Ninth Circuit, the leading authority concerning the survival of equitable claims is *In re Irizarry*, 171 B.R. 874 (9th Cir. BAP 1994). In that case, debtor Renee Irizarry obtained a discharge in bankruptcy while a state legal action was pending against her which sought both legal and equitable remedies. After the discharge, the creditors renewed their state claim for equitable relief (cancellation of a deed). Irizarry responded by bringing an action in the bankruptcy court seeking an injunction against enforcement of the state court action.

The bankruptcy court granted the creditors' summary judgment motion, and Irizarry appealed. In upholding the bankruptcy court's order, the Ninth Circuit Bankruptcy Panel held that the equitable remedies sought by the creditors did not constitute claims or debts subject to discharge. Although the creditors could have claimed monetary damages, and did, before the bankruptcy, they did not attempt to pursue them after the bankruptcy, and the Court thus held that

> [N]one of the equitable remedies sought by the [creditors] have a money damage alternative in the event of non-performance by the Debtor. . . .
>
> Because the equitable remedies in question do not constitute a claim, as defined in § 101(5), or a debt, as defined in § 101(12), they are not affected by the discharge of all debts granted by the bankruptcy court.

*Id.* at 879. Since the claim for equitable relief was not dischargeable in the bankruptcy, the debtor was not entitled to enjoin the state court proceedings as a matter of law.

While the underlying claim in *Irizarry* was not based on a contract, it stands for the proposition that if a creditor chooses to pursue a purely equitable remedy, whether or not he could be entitled to monetary damages for the same wrong, the pursuit of an equitable remedy occurs outside of the bankruptcy proceedings and is not affected by them. In this case, the Church has pursued and obtained the equitable relief of specific performance of the non-disclosure provisions of the contract. The state court specifically found that legal remedies were inadequate, and that an injunction was both necessary and proper.

Even closer factually is the case of *In re Udell*, 18 F.3d 403 (7th Cir. 1994). In *Udell*, the debtor's employment contract with Carpetland included a covenant not to compete, which gave Carpetland the right to both an injunction and liquidated damages in the event of a breach. Soon after Udell left Carpetland, he purchased a local carpet store, and sued Carpetland for claimed breaches of the employment agreement. Carpetland counterclaimed, seeking damages and an injunction, and was granted a preliminary injunction. While that injunction order was on appeal, Udell filed a Chapter 13 bankruptcy petition.

Carpetland asked the bankruptcy court for relief from the automatic bankruptcy stay in order to enforce its preliminary injunction in the state court. The bankruptcy court granted the relief, finding that Carpetland's right to injunctive relief was not a claim dischargeable in bankruptcy. The reasoning of the bankruptcy court (which was later adopted by the Seventh

Circuit) is particularly instructive to our case. The bankruptcy court held that:

> Under Indiana law, an injunction may issue only if the remedy of damages is inadequate. The state court had ruled in this case that an injunction is the proper remedy for Udell's breach, and under the strictures of Indiana law, this ruling necessarily encompasses a decision that the right to the injunction could not be satisfied by the payment of liquidated damages.[6] Accordingly the breach that gives rise to the injunction does not "give rise to a right to payment" under § 101 (5)(B).

18 F.3d at 405.

The district court, however, reversed the bankruptcy court, holding that because the breach of the covenant not to compete entitled Carpetland to seek liquidated damages as well as an injunction, Carpetland's request for injunction was, indeed, a § 101(5)(B) claim subject to discharge.

In a detailed opinion, the Seventh Circuit reversed the district court. After reviewing pertinent Supreme Court authority,[7] the court held that even if a single contractual breach gives

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[6] California has the same requirement for the issuance of an injunction ordering specific performance of a contract, *Tamarind Lithography Workshop, Inc. v. Sanders*, 143 Cal.App.571, 575, 193 Cal.Rptr. 409, 412 (1983). In our case Judge Thomas specifically found that "Plaintiff's legal remedies are inadequate insofar as the scope of the relief ordered . . . is concerned." Order of Permanent Injunction at 6.

[7] Relevant to the Seventh Circuit's determination was an environmental case, *Ohio v. Kovacs*, 469 U.S. 274, 105 S.Ct. 705, 83 L.Ed.2d 649 (1985). Kovacs owned a chemical and dye company, found to be polluting the ground and water in violation of Ohio's environmental protection laws. Ohio obtained an injunction ordering Kovacs to clean up the site, and to refrain from polluting in the future. When Kovacs did not obey the clean up order, a receiver was appointed and clean up begun. Ohio tried to recover from Kovacs the cost of the clean up, and Kovacs filed for bankruptcy.

The Supreme Court found that since "the only type of performance in which Ohio is now interested is a money payment to effectuate the Chem-Dyne cleanup," 469 U.S. at 282, the affirmative injunction to cleanup past hazardous waste was a claim which fell within the purview of § 101(5)(B), and could be discharged. However, the Court specifically noted that the negative injunction not to pollute in the future could not be so discharged, stating:

> [W]e do not hold that the injunction against bringing further toxic wastes on the premises or against any conduct that will contribute to the pollution of the site or the State's waters is dischargeable in bankruptcy. . . .

*Id.* at 284-285.

The instant case, like that in *Kovacs*, involves a purely "negative" injunction. Armstrong is not

rise to both a claim for damages and a claim for injunctive relief, the claim for injunctive relief is not a claim that can be discharged in bankruptcy. The distinction to be drawn is between conjunction and alternative remedies. If both remedies are available simultaneously (conjunctive), the injunction will not be discharged. If the court or one of the parties must choose between the two remedies (alternative), the injunction will be discharged.

Next, the Court turned to Indiana law, and ascertained that "'with the great weight of authority in this country,' Indiana law permits (under proper circumstances) the award of an injunction in addition to liquidated damages." 18 F.3d at 408. Analyzing the circumstances of the covenant not to compete case, the Court noted,

> A threatened breach could give rise to two independent remedies: (1) an injunction against the future realization of the threat, and (2) liquidated damages for the actual harm that has already accrued from the threat. Carpetland's right to liquidated damages does not arise "with respect to" its right to an injunction; the two rights address entirely separate remedial concerns. . . . As *Kovacs* shows, the fact that both remedies are triggered by a single act does not mean that the right to an injunction gives rise to a right to liquidated damages.

*Id.* at 409.

In the instant case, not only does California law permit liquidated damages and an injunction to be conjunctive remedies, the State Court has already found them to be conjunctive, and awarded both. Moreover, it is very clear from the Agreement and the Permanent Injunction that, as in *Udell*, the injunction is intended to prevent future breaches, while the damages were awarded because of harm done by specific past breaches. Indeed, the contract does not even

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required to affirmatively expend resources or do anything in upholding his obligations under the Permanent Injunction. Rather, Armstrong is simply restrained from undertaking any of the actions listed in the permanent injunction order. The distinctions made in *Kovacs* have been applied in later cases, see, e.g., *Udell* and *Kovacs*, *supra*.

provide a remedy of liquidated damages for many of the breaches which the state court found Armstrong had committed.[8]

*Accord*, *In re Davis*, 3 F.3d 113 (5th Cir. 1993) In finding that equitable remedies granted by the state court in conjunction with the same breaches of fiduciary duty which also gave rise to monetary claims were not "claims" which could be discharged in bankruptcy, the Fifth Circuit held:

> We decline to define "claim" so broadly. Section 101(5)(B) is designed to cause the liquidation of contingent claims for money damages that are *alternatives* to equitable remedies . . . . The ability of a debtor to choose between performance and damages in some cases is not the same as a debtor's liability for money damages for failing to satisfy an equitable obligation. While section 101(5)(B) encourages creditors to select money damages from among alternative remedies, it does not require creditors entitled to an equitable remedy to select a suboptimal remedy of money damages.

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[8] Also stressing the distinction of an equitable remedy to restrain future conduct, as opposed to a legal remedy to compensate for past conduct, is the later case of *Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994). Here, the debtor, Hiles, owned land in a subdivision in Scherville, Indiana which was subject to a reciprocal restrictive covenant, limiting its use to residential properties. Hiles obtained permission from the city to build a music store on the site. Her neighbors brought a state court action to enforce the restrictive covenant. The trial court found the covenant to be unenforceable. While the neighbors appealed, Hiles built her music store. The court of appeals reversed the trial court, finding the covenant enforceable, and permanently enjoined Hiles from building a music store, leaving Hiles with a large, empty building that could not be used.

Hiles filed a Chapter 11 bankruptcy. She and the bankruptcy trustee tried to sell the building, free of the restrictive injunction, arguing that (1) the covenant was an executory contract which Hiles could reject; and (2) the neighbors' interest was an interest convertible to money damages, and therefore just another claim against the estate. The bankruptcy court rejected her plan, and both the district court and the Court of Appeal affirmed.

The court examined the equitable right of the neighboring landowners to enforce the covenant through equitable relief (as here, by permanent injunction) and, following *Udell*, found since the covenant allowed the landowners to pursue both legal and equitable relief, the landowners could not be compelled to assert a claim for damages against the bankruptcy estate in lieu of their state court injunction. In the face of an appeal from the trustee in bankruptcy that the court should use its general equitable powers to permit the desired sale, the court stated, "We will not invoke § 105(a) under a general equitable power to set aside a valid, permanent injunction from an Indiana state court." *Id.* at 301.

3 F.3d at 116.

After reviewing the specifics of the equitable remedies imposed against Davis, the Court found that they did not have adequate monetary alternatives:

> We find that the resulting trust remedy does not have a money damage alternative. . . . This remedy is analogous to an injunction preventing Davis from committing future wrongs, which is an intangible command incapable of precise monetary estimation. . . .
>
> We take a similar view of the remedy of reformation. The trial court viewed this as a prospective remedy imposed "in order to prevent further inequitable conduct on the part of . . . Davis. Money is not an alternative to this kind of command. This remedy is also not dischargeable.

*Id.* at 117.

The injunction against Armstrong, like these remedies against Davis, is intended "to prevent further inequitable conduct," and has no adequate monetary alternative.

Bankruptcy courts in California have applied similar reasoning. In *In re Carrere*, 64 B.R. 156 (Bkrtcy. C.D. Cal., 1986), the bankruptcy court held that actress Carrere could not use bankruptcy court to avoid a personal services contract, when California law permitted contracting party to obtain an injunction preventing her from accepting a second, more lucrative contract after breaching the first. After determining that the personal services contract at issue was not one which the bankruptcy estate could actually either assume or reject, the court undertook the following analysis:

> Rejection of an executory contract constitutes a breach, which is deemed to have occurred immediately before the date of the filing of the petition. The claim for monetary damages thus becomes a claim in the estate. *But a rejection under the Bankruptcy Code only affects the monetary rights of the creditor. It does not disturb the equitable, non-monetary rights that the creditor may have against the debtor because of the breach of contract.* . . .
>
> California law has given ABC an equitable remedy: to seek a negative injunction against Carrere and thereby prevent her from performing elsewhere. Rejection of the ABC contract would not interfere with any claim for monetary damages as a pre-petition debt. Therefore, whether this Court were to allow

> rejection or not, Carrere cannot use the Bankruptcy Code to protect her from whatever non-monetary remedies are enforceable under state law.

64 B.R. 160 (emphasis supplied, citations omitted).

Like the contract in *Carrere*, the Agreement is not an executory contract which could be subject to rejection by Armstrong or the trustee.[9] Even assuming arguendo, however, that the contract could somehow be deemed executory, the *Carrere* case makes it clear that Armstrong cannot, by filing for bankruptcy and rejecting it, cut off the Church's right to equitable relief for his breaches. And the equitable relief provided to the Church by California law is in the form of the permanent injunction already granted by the state court. *Accord*, *In re Mercury Homes Development Co.*, 4 Bankr.Ct.Dec. 837 (Bkrtcy.N.D.Cal. 1978) (Buyer under land sale contract was entitled to remedy of specific performance of the contract even though contract was executory, and could be rejected by the seller. Rejection simply ensured that any monetary claim would be discharged in bankruptcy; it had no effect on the equitable remedy of specific performance.)

In other states, the most frequently litigated form of injunctive relief, by far, comes in the area of covenants not to compete after the sale of a business or the ending of an employment relationship. Almost uniformly, the bankruptcy courts have held that when a contract includes

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[9] The Ninth Circuit defines an executory contract as," [O]ne on which performance is due to some extent on both sides. Also, in executory contracts the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other." *In re Wegner*, 839 F.2d 533, 536 (9th Cir. 1988)(citations omitted). Further, "If either party has 'substantially performed' its side of the bargain, such that the party's failure to perform further would not excuse performance by the other party, then the contract is not executory." *In re Texscan*, 976 F.2d 1269, 1272 (9th Cir. 1992).

Here, the Church fully performed all of its material obligations under the contract, and the state court has so held. Armstrong's failure to abide by the negative covenant contained in the agreement cannot render the contract executory, since literally nothing remains for the Church to do, and its performance cannot be excused.

a covenant not to compete, that covenant cannot be rejected by the party affected, and the right of the aggrieved party to seek and obtain an negative injunction enforcing the covenant cannot be discharged. These cases provide a factual scenario very similar to that presented to the Court here.

Typical is *In re Oseen*, 133 B.R. 527 (Bkrtcy.D.Idaho 1991). The debtor in *Oseen* sought to reject as "executory" a partnership dissolution agreement, but the only part of the contract remaining to be performed was Oseen's agreement not to engage in a competitive business for a period of five years. Prior to the bankruptcy proceeding, Oseen had breached the non-competition clause. The partner sued him in state court, and the state court issued a preliminary injunction. After Oseen filed for bankruptcy, the partner obtained relief from the bankruptcy stay to obtain a determination by the state court as to the enforceability of the covenant not to compete. The state court found that the covenant was enforceable.

The bankruptcy court held, first, that the contract was not executory, because all that remained to be performed was for the debtor to refrain from competing with his partner. Next, the court found that the partner's claim for equitable relief arising out of breach of the non-competition clause was not a claim that could be discharged in bankruptcy, even though the contract included a liquidated damages clause. The circumstances described parallel the instant case:

> In this case, the parties anticipated the obvious difficult in calculating any actual damages associated with a breach of the non-competition covenant by insertion of a liquidated damages clause in their agreement. However, such is not an effective remedy for any future breach of the covenant, and the state court found Defendant met the burden for proving her entitlement to an injunction. Therefore, under the facts presented here and in light of the state court's judicial determination, it is clear that the equitable remedy (i.e., the injunction) provided in Defendant's favor in the contract did not give rise to a right to payment, and Plaintiff's obligation to refrain from competing with Defendant is not a claim that may be discharged.

133 B.R. at 531.

So, here, the liquidated damages provision in the Agreement, pertaining to a single type of breach, "is not an effective remedy for any future breach of the [Agreement], and the state court found that [the Church] met the burden for proving [its] entitlement to an injunction." *Id.* Accordingly, "in light of the state court's judicial determination, it is clear that the equitable remedy (i.e., the injunction) provided in [the Church]'s favor in the contract did not give rise to a right to payment. . . ." *Id.* The Permanent Injunction is thus not a claim which may be discharged.[10]

In contrast, research disclosed only three covenant not to compete cases which held that the franchisor or buyer was not entitled to seek equitable relief in spite of the bankruptcy: *In re Register*, 95 B.R. 73 (Bkrtcy.M.D.Tenn. 1989), aff'd 100 B.R. 360 (M.D.Tenn 1989); *In re*

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[10] The overwhelming majority of cases hold similarly: *In re Thomas*, 133 B.R. 92 (Bkrtcy. N.D. Ohio, 1991) (Claim for injunction enforcing covenant not to compete found in contract for sale of beauty salon could not be discharged in bankruptcy); *In re Hawes*, 73 B.R. 584 (Bkrtcy.E.D.Wis., 1987) (Former employer granted relief from Chapter 13 stay to pursue state court remedy of injunction against debtor); *In re Cox*, 53 B.R. 829 (Bkrtcy. M.D.Fla., 1985) (Former employer given relief from stay under a Chapter 7 to pursue a state court remedy of injunction enforcing covenant not to compete against debtor); *In re Noco*, 76 B.R. 839 (Bkrtcy.N.D.Fla. 1987) (Franchise agreement was not an executory contract, and franchisor was entitled to pursue non-competition injunction against debtor in state court); *In re Cooper*, 47 B.R. 842 (Bkrtcy.W.D.Mo. 1985) (Relief from automatic stay granted to former employer to seek state court injunction prohibiting debtor from further violating covenant not to compete); *In re Cherry*, 78 B.R. 65 (Bkrtcy. E.D.Pa. 1987) (Former employer granted relief from automatic stay to pursue action for contempt against debtor who was violating state court injunction enforcing covenant not to compete); *In re Peltz*, 55 B.R. 336 (Bkrtcy. M.D.Fla. 1985) (Employer granted limited relief from the discharge injunction in order to pursue a state court injunction to enforce a covenant not to compete, although employer's claim for damages was discharged); *In re Don & Lin Trucking Co., Inc.*, 110 B.R. 562 (Bkrtcy.N.D.Ala. 1990) (Even if a contract is rejected in bankruptcy, debtor is not relieved of obligation on covenant not to compete; creditor is permitted to pursue a claim for equitable relief if it is violated); *In re Hirschorn*, 156 B.R. 379 (Bkrtcy.E.D.NY 1993) (Bankruptcy court, applying state law, issued a permanent injunction prohibiting debtor from practicing podiatry within six blocks of creditor's building for two years, upholding non-compete provision in lease agreement).

*Audra-John Corp.*, 140 B.R. 752 (Bktrcy.D.MN 1992); and *In re Kilpatrick*, 160 B.R. 560 (Bktrcy.E.D.MI 1993). And even if the reasoning used in each of these cases were adopted here, this Court would still be compelled to find that the Permanent Injunction is not a dischargeable claim.

In *Register*, the court considered cases such as *Carrere* and *Noco*, *supra*, but declined to follow them. Rather than following the well-established rule that state law applies in determining whether or not a remedy is a dischargeable claim, the court stated, "[a]lthough state courts have ruled that they cannot put a value on the injury incurred for breach of these covenants this Court believes that it can," 95 B.R. at 75, and ordered the creditor to submit a claim for monetary damages. To the extent that the court articulated a reason for not following the other cases, it stated only that the other cases contained elements of "bad faith" in the filing, and the Registers did not.

Here, there is plain evidence of bad faith in Armstrong's filing. He has admitted that he has re-affirmed every other debt, leaving only his dispute with the Church to be resolved in this forum, rather than the state court forum [Ex. 11 at 7:2-4] Further, in his newly executed trial declaration, he reiterates that he is displeased with Judge Thomas's rulings, and would like this Court to overrule those orders, and declare the Agreement invalid [e.g., Armstrong Declaration of February 6, 1996, at ¶¶47-49]. Finally, Armstrong states in his new declaration that he wants this Court to invalidate the injunction so that he can breach the non-disclosure provisions of the Agreement while "canvasing for amici curiae," and "seeking public office in Canada." [Armstrong Dec. at ¶48] It is thus clear from Armstrong's own words that his purpose in bringing this petition is to avoid the terms of the Agreement which he made, and pursuant to which the Church paid him more than half a million dollars.

In *re Audra-John Corp., supra*, the bankruptcy court concluded that the creditor had not

met its burden of demonstrating that it would, in fact, ever be entitled to an injunction under Ohio law, and permitted the debtor to reject the agreement at issue, specifically including the non-competition clause.

*Audra-John* is easily distinguished. Here, not only is the Church entitled to a permanent injunction enforcing Armstrong's non-disclosure agreement, it already has gotten one. Even the *Audra-John* court conceded that the determination of entitlement to an equitable remedy is a matter of state law, and not a matter for the independent determination of the bankruptcy court.[11]

All of these cases, then, support the conclusion that the Permanent Injunction, ordered by the state court, is not a claim which can be reduced to a monetary value, and discharged in bankruptcy.

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[11] *Kilpatrick* is also easily distinguished. In that case, the debtor sold his garbage trucks to the creditor, via an agreement containing a covenant not to compete, and then began to compete with the creditor. The creditor obtained a preliminary injunction enforcing the non-compete clause. The debtor filed a Chapter 13 plan, got it confirmed, and went back into the trash-hauling business.

The creditor sought permission from the bankruptcy court to pursue a civil and criminal contempt action against the debtor for his violation of the injunction. The bankruptcy court determined that the creditor's rights under the non-compete clause could be converted into a monetary judgment, in spite of the state court's determination, on preliminary injunction, that money damages were not an adequate remedy for the debtor's breach. As in *Audra-John*, the court reasoned that it was the creditor's responsibility to show that no amount of damages could reasonably compensate it for the resulting losses, and that it had not met its burden of proof. It then quickly translated the creditor's injunction into a claim against the estate for damages, and denied the creditor any relief to pursue enforcement of its injunction.

The reasoning in *Kilpatrick* is inadequate because it does not address the problem of future injury, something which has been stressed by every appellate court to consider the question of the survival of equitable claims. Moreover, the case relies heavily on the district court opinion in *Udell*, which was reversed by the Seventh Circuit. Even so, the case still supports the view that the injunction in this case is not dischargeable. Here, the state court has ruled with finality that the Church had no adequate remedy at law, and that only an injunction would prevent Armstrong from further breaching the agreement.

## IV.

## ARMSTRONG IS NOT ENTITLED TO DISCHARGE PURSUANT TO BANKRUPTCY CODE SECTION 727(a)(4)(A)

Section 727(a)(4)(A) of the Bankruptcy Code provides that a debtor will not be granted a discharge if "the debtor knowingly and fraudulently, in or in connection with the case. . .made a false oath or account." False oaths which will be found to justify the denial of discharge include "(1) a false statement or omission in the debtor's schedules or (2) a false statement by the debtor at the examination during the course of the proceedings." 4 *Collier on Bankruptcy* ¶ 727.04[1], at 727-59 (15th Ed. 1992). This is because

> Full disclosure of assets and liabilities in the schedules required to be filed by one seeking relief under Chapter 7 is essential, because the schedules "serve the important purpose of insuring that adequate information is available for the Trustee and creditors without need for investigation to determine whether the information provided is true.

*In re Beaubouef*, 966 F.2d 174, 179 (5th Cir. 1992). The false statement must be one which is material, and the courts have consistently held that

> The subject matter of a false oath is "material," and thus sufficient to bar discharge, if it bears a relationship to the bankrupt's business transactions or estate, or concerns the discovery of assets, business dealings, or the existence and disposition of his property.

*Id.* at 178, quoting *In re Chalik*, 748 F.2d 616, 617 (11th Cir. 1984).

In this case, the evidence will show that Armstrong claimed to have no stocks or other business interests on Schedule B to his bankruptcy petition [Ex. 10]. Yet, he admitted in his debtor's examination that he presently is a stockholder of a corporation which he formed called the Gerald Armstrong Corporation ("GAC") [Ex. 11 at 6:18-20 and 10:17 - 11:7]. Armstrong asserted to the Trustee at that time that GAC's assets have "no commercial value." [*Id.* at 6:20-21] However, he made no effort to amend his petition to include his interest in GAC. The

Church's efforts to question Armstrong about GAC's assets were cut short at the examination [*Id.* at 11:26-12:8], and Armstrong refused to respond to the subpoena duces tecum which the Church subsequently posed to the corporation [Ex. 21-26].

Armstrong's statements that GAC's assets are completely worthless are highly suspect, because of his earlier testimony in the state court action. The evidence is that he testified that he incorporated GAC in 1987, infusing $10,000 in capital. [Ex. 12; Ex. 11 at 10:24-11:1] In 1992, Armstrong testified that GAC owned "original artwork. . . certain inventions and formulas," "machinery or tools," "equipment and products," all of which it either acquired from Armstrong or purchased. [Ex. 14 at 463-466] At the corporation's inception, Armstrong owned 100% of the stock. [Ex. 16 at 89:16-90:6] Armstrong testified under oath in March of 1993 that he gave away the stock in GAC in 1990, and that the value of the stock at the time was "[a] million." [Ex. 15, 545:19-546:5] Armstrong swore that his valuation of the worth of GAC was based on pieces of work which he had evaluated, and which had an appraised value of $900,000, although he refused to identifier the appraiser, beyond stating that it was someone other than himself. [*Id.* at 547:7-18]

The evidence will also show that all of Armstrong's transfers of the stock of GAC in 1990 were done to his friends and family [Ex. 16 at pages 2-3 of letter; Ex. 4 to deposition; Ex. 17], with little or no monetary exchange. By 1993, he had reacquired all but 20% of the stock [Ex. 15 at 557:2-11]. He testified that he is GAC's sole employee, and the sole signatory on GAC's bank account [Ex. 14 at 461:6-15].

Armstrong has tried to argue to this Court that his failure to include GAC on his schedules was due to inadvertence, rather than a deliberate attempt to omit assets. But his insistence to the referee that the corporation is "worthless," together with his refusal to permit discovery by the creditor of its actual assets, render his argument less than credible.

Indeed, it is well-established that

> The recalcitrant debtor may not escape section 727(a)(4)(A) denial of discharge by asserting that the admittedly omitted or falsely stated information concerned a worthless business relationship or holding; such a defense is specious. It makes no difference that he does not intend to injure his creditors when he makes a false statement. Creditors are entitled to judge for themselves what will benefit, and what will prejudice, them. The veracity of the bankrupt's statements is essential to the successful administration of the Bankruptcy Act.

*In re Chalik*, *supra*, 748 F.2d at 617 (citations omitted). Moreover,

> [d]ebtors are required to come to the bankruptcy court with open books and records, disclosing in the first instance, all of their transactions. . . .Merely "glancing" at the typed petition and schedules does not comport with the requirements of the Bankruptcy Code. Debtors have an affirmative duty to disclose in order to obtain the incredible relief afforded by the "fresh start" in bankruptcy.

*In re Smith*, 161 B.R. 989, 991 (Bnkrtcy.Ct.E.C.Ark. 1993). In *Chalik*, the debtor was denied a discharge because he failed to list on his schedules "certain corporations with which he was associated or in which he held stock," even though he revealed them during his examination, and the assets were deemed by the trustee to be worthless. *Accord, In re Beaubouef*, 966 F.2d 174, 179 (5th Cir. 1992) (Debtor denied discharge for failure to list ownership interest in company he claimed "did no business, had no customers, and his only relationship with the business was as an employee."); *In re Olson*, 916 F.2d 481 (8th Cir. 1990) (Debtor failed to include interest in a failed dinner theatre); *Farmers Co-operative Association of Ralmage, Kansas v. Strunk*, 671 F.2d 391 (10th Cir. 1982)(Debtor denied discharge for failure to list bank account although he believed account was overdrawn at time of bankruptcy filing.).

The evidence thus will support a finding that Armstrong willfully made a false oath, in his bankruptcy petition and/or before the Trustee in bankruptcy during his examination, and is for that reason not entitled to discharge.

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## V.

## ARMSTRONG IS NOT ENTITLED TO DISCHARGE PURSUANT TO BANKRUPTCY CODE SECTION 727(a)(5)

Section 727(a)(5) of the Bankruptcy Code provides that a court may deny the debtor discharge when "the debtor has failed to explain satisfactorily, before termination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor's liabilities." Once a creditor shows a basis for raising an objection pursuant to this section, the burden "shifts to the [debtor] to explain the loss of [his] cash assets in a satisfactory manner." *In re MacPherson*, 129 B.R. 259, 261 (M.D.Fla. 1991). "The debtor will be required to produce some kind of direct, specific evidence in order to defeat an objection [of discharge] based upon failure to explain a loss of assets." *In re Ridley*, 115 B.R. 731, 737 (Bnkrtcy.D.Mass.1990) (citing *McBee v. Sliman*, 512 F.2d 504, 506 (5th Cir. 1975)).

Here, the evidence will show that Armstrong claimed substantial assets, including the proceeds of his settlement with the Church, prior to 1990 [Ex. 14 at 463:12-466:20; Ex. 15 at 536:13-18, 540:9-11, 541:19-542:9; Ex. 16 at 89:16-90:6]. The evidence will also show that Armstrong claims that in August, 1990, acting on directions from the Almighty, he "gave away" (to his close friends and family), a great deal of cash, a house, and "forgave" substantial debt, totalling at least $200,000 [Ex. 11 at 8:6-11:3; Ex. 15 at 542:19-23, 545:7-21; Ex. 16 at 26:8-16, 30:3-33:2, 81:13-82:16, 85:25-87:19]. It was not until Armstrong had thus given away or hidden all of his assets that he began breaching the Agreement [Ex. 8(c)]. Armstrong has also admitted that he re-acquired GAC, which he had established as a repository for all of his literary and artistic works, and which he claimed had assets in 1993 of "a billion." Even assuming *arguendo* that Armstrong's sworn valuation of GAC's assets is inflated, he still offered no reasonable explanation for his statement to the trustee in 1995 that the corporation was "suspended" and

owned nothing of commercial value [Ex. 11].

Debtors are not permitted to simply assert that their lifestyle caused them to dissipate all of their assets, and use that unverified comment to justify their inability to pay their creditors. *In re Dolin*, 799 F.2d 251 (6th Cir. 1986) (Claimed gambling habit and drug addiction deemed an unsatisfactory explanation); *In re Moore*, 89 B.R. 935 (Bkrtcy.M.D.Fla. 1988) (Failure to explain loss of $28,000, claimed for living expenses, prevented discharge); *Lowe's of Virginia, Inc. v. Thomas*, 60 B.R. 418 (W.D.Va. 1986) (Vague and unspecific explanation of dissipation of $30,000 insufficient).

Here, Armstrong had known assets of at least $518,000, and conceded having substantial assets in 1990. His only explanation -- that he gave some of it to friends to enhance himself spiritually -- does not explain where the rest went, and, indeed, is itself unsatisfactory. The evidence will thus demonstrate this as a separate, independent basis to deny Armstrong discharge.

## VI.

## CONCLUSION

Armstrong is not entitled to discharge his debts in bankruptcy, because he lied on his bankruptcy schedules, and he lied to the Trustee. In addition, he is not entitled to a discharge because he has no satisfactory explanation for the dissipation of at least $518,200 in assets.

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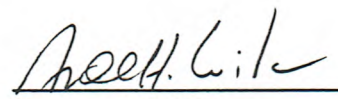
Finally, whether or not Armstrong's debts are discharged, the Church is entitled to a determination that the Permanent Injunction ordered by the State Court is not a debt or claim which Armstrong may discharge.

Dated: February 13, 1996

Respectfully submitted,

WILSON, RYAN AND CAMPILONGO

By: 

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PROOF OF SERVICE

I declare that I am employed in the City and County of San Francisco, California.

I am over the age of eighteen years and not a party to the within entitled action. My business address is 115 Sansome Street, Suite 400, San Francisco, California.

I am readily familiar with Wilson, Ryan & Campilongo's practice for collection and processing of correspondence for hand delivery.

On February 13, 1996, I caused to be hand served the attached **TRIAL BRIEF** on the following in said cause, on this day in the ordinary course of business, true copies thereof enclosed in a sealed envelope. The envelope was addressed as follows:

Gerald Armstrong
715 Sir Francis Drake Blvd.
San Anselmo, CA 94960-1949

I declare under the penalty of perjury pursuant to the laws of the State of California that the foregoing is true and correct and that this Proof of Service was executed on February 13, 1996 at San Francisco, California.

Colleen Y. Palmer

COLLEEN Y. PALMER

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